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Electronic Deposit of Income Tax Refunds

This memorandum responds to your oral request concerning whether the Commissioner is required to honor taxpayers' requests to transmit their tax refunds electronically to financial institutions rather than mail refund checks directly to the taxpayers.

FACTS

The issue arises in the context of refund anticipation loans (RAL). As we understand the RAL process, if it appears that a taxpayer is due a refund, the return preparer advises the taxpayer that he/she may apply for a refund anticipation loan. If the taxpayer is interested in obtaining a RAL, the return preparer refers the taxpayer to a financial institution to arrange the loan. As part of this process, the taxpayer fills out a loan application and signs a contract authorizing the financial institution to establish a bank account to receive the taxpayer's tax refund.

The return preparer and the taxpayer file a Form 8453, U.S. Individual Income Tax Declaration for Electronic Filing, designating the financial institution to receive the income tax refund via electronic funds transfer (EFT). The Service has no involvement with the RAL. The taxpayer is typically notified within forty-eight hours if the loan has been approved or denied. If the loan is approved, the financial institution establishes an account in the name of the taxpayer. The account is established for the sole purpose of receiving the taxpayer's tax refund electronically and satisfying the RAL. The taxpayer's account contains the taxpayer's social security number for identification purposes. The financial institution typically lends the taxpayer the amount of the refund less the fee for the loan and the fee for the preparation of the return. The lender attaches a truth in lending statement to the taxpayer's loan check.

After the Service has determined that the taxpayer is entitled to the income tax refund, the Service transmits the refund via EFT for deposit into the RAL account designated on the

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Form 8453. Per the agreement between the taxpayer and the lending institution, the refund is used to satisfy the RAL debt. If the refund amount is for the exact amount of the loan to the taxpayer, the loan is paid in full. If the refund amount is more than the loan to the taxpayer, the financial institution applies the money in the taxpayer's RAL account to satisfy the RAL debt, then sends the taxpayer a paper check for the excess amount. If the refund amount is less than the loan to the taxpayer, the financial institution applies the refund to satisfy part of the RAL debt, then sends the taxpayer a bill for the difference between the loan and the tax refund.

Once the RAL loan is satisfied, the financial institution places the taxpayer's account in inactive status. The financial institution may reactivate the account if the same taxpayer applies for a RAL in the following year.

ISSUES

1. Is the Commissioner required to honor taxpayers' requests made on Form 8453 to have their income tax refunds deposited via EFT into their accounts at financial institutions?
2. Is the Commissioner required to honor taxpayers' requests to have their income tax refunds deposited via EFT into a third-party's account at a financial institution?

CONCLUSIONS

1. No. The Commissioner is not required to honor taxpayers' requests made on Form 8453 to have their income tax refunds deposited via EFT into their accounts at financial institutions. Under section 6402 of the Internal Revenue Code of 1986, the Commissioner may disregard a taxpayer's payment designation and pay a refund directly to the taxpayer.
2. No. The Commissioner can not honor taxpayers' requests to have their income tax refunds deposited via EFT into a third-party's account at a financial institution. Section 6402 of the Code and the Anti-Assignment Act, 31 U.S.C. § 3727, prohibit such assignments.

DISCUSSION

The Commissioner's Obligations in Determining Overpayments

The Commissioner has the authority to credit the amount of an overpayment against any internal revenue tax liability of the "person who made the overpayment" and "refund any balance to such person." See section 6402(a) of the Code. Pursuant to section 6402 of the Code, the Service is required to determine whether an

overpayment exists in order to process the claim. If an overpayment exists, the Service is required to refund the overpayment, in excess of any outstanding internal revenue tax liability, to the taxpayer. See section 301.6402-2(f) of the Regulations on Procedure and Administration. However, before the determined overpayment is refunded to the taxpayer, the Commissioner is required to offset any refund by past due child support, debts owed to federal agencies, and for overpayments of Old Age Survivors and Disability Insurance.¹ See sections 6402(c) and (d) of the Code.

As a general rule, a claim for the credit or refund of an overpayment in income tax must be made on the return filed for the tax year. A return qualifies as claim for refund if it sets forth the amount of the overpayment and provides directions as to its refund or application. See section 301.6402-3(a)(5) of the regulations. Claims for refund must be filed with the service center serving the internal revenue district in which the tax was paid. See section 301.6402-2(a)(2) of the regulations. Once a claim for refund is received by the Service, service center personnel scrutinize the claim for completeness, validity, and timely filing. Service personnel determine whether the claim involves audit matters or should be processed at the service center. See IRM 4511 (Centralized Classification of Claims) and IRM 4512 (Preliminary Examination & Disposition of Claims Referred to Examination).

Once a claim for refund has been rejected by the Service, there no longer is a claim pending before the Service. Allstate Insurance v. United States, 550 F.2d 629 (Ct. Cl. 1977). At that time, the taxpayer has the option of filing a refund suit in either a federal district court or the United States Court of Federal Claims. See sections 7422 and 6532(a) of the Code.

The Commissioner's Obligations in Refunding Overpayments

Section 6402(a) of the Code authorizes the Service to credit the amount of an overpayment against any internal revenue tax liability of the "person who made the overpayment", and directs the Service to "refund any balance to such person." Section 301.6402-2(f) of the regulations provides that checks in payment of claims allowed will be drawn in the names of the persons entitled to the money; and, the checks may be sent directly to the claimant or to such person in care of an attorney or agent pursuant to a power of attorney specifically authorizing the designated attorney or agent to receive such checks. Section 301.6402-2(f) of the regulations was last amended in 1977 before

¹. Special rules exist for the offset of tax refunds in certain bankruptcy situations. See 11 U.S.C. § 362(a) and (d).

the Service began issuing electronic refunds. However, the payment and designation principles contained in the regulations apply equally to paper and electronic refunds.

It is clear the Service has the authority either to honor or to dishonor taxpayers' payment designations. Section 301.6402-2(f) of the regulations provides that refund checks "may" be sent directly to the claimant or to such person in care of an attorney or agent pursuant to a power of attorney specifically authorizing the attorney or agent to receive such checks. Therefore, the Service has the discretion to send the refund check to either the taxpayer or the authorized representative.²

The Service's refund practice for large refunds is instructive. In Announcement 85-14, 1985-4 I.R.B. 43, the Service stated that individuals as well as business taxpayers who receive tax refunds of one million dollars or more will be able to request the wire transfer of their refunds to their financial institutions beginning January 1, 1985. A taxpayer can make this request by filing Form 8302, Application for Electronic Funds Transfer (EFT) of Tax Refund of \$1 Million or More. The instructions to Form 8302 state that the electronic funds transfer is an "option" available to the taxpayer. The Service will not allow taxpayers to designate another person to accept the wire transfer refund, and the wire transfer does not constitute an assignment of the taxpayer's right to receive the refund.

One court has considered the Service's failure to honor a Form 8302 payment designation. In Onan Corp. v. United States, 19 Cl. Ct. 678 (1990), the plaintiff had filed an application for a corporate tax refund. Due to the size of the anticipated refund, the plaintiff requested that its refund be issued via EFT directly to its bank account, rather than by paper check sent through the mail. The plaintiff submitted this request in the appropriate manner on Form 8302. Later, the Service notified the plaintiff that it was entitled to the refund. The Service then issued plaintiff's refund by paper check rather than via EFT.

The plaintiff subsequently filed a claim with the Service seeking to recover additional interest for the period of time from the date of the refund check until the date plaintiff received the check. Plaintiff argued that the Service's failure to honor its application for a wire transfer of its refund

² "[I]n construction of statutes and presumably also in construction of federal rules [the] word 'may' as opposed to 'shall' is indicative of discretion or choice between two or more alternatives" See Black's Law Dictionary 979 (6th ed. 1990).

resulted in the loss of the use of the refund money for fourteen days. The Service disallowed the plaintiff's claim for interest. The plaintiff then filed suit in the United States Claims Court. Thereafter, the United States filed a motion to dismiss for failure to state a claim upon which relief may be granted. The court granted the United States' motion and dismissed the case.

The court held that the mere fact that the Service offered the option of an EFT to taxpayers does not, of itself, create a right in favor of taxpayers to have the Service honor taxpayers' wire transfer requests in every case. The court noted that the wire transfer policy is not mentioned in any statute or regulation. Likewise, since the wire transfer procedures were not implemented to facilitate existing constitutional rights of taxpayers, the Service had no obligation to provide the EFT option to taxpayers. As such, the court found that the Service did not intend to create a substantive right for which taxpayers would have a remedy of additional interest in the event that the Service chose not to implement its procedure in a particular case. Onan Corp., 19 Cl. Ct. at 681.

Following the reasoning of Onan Corporation, it is clear that filing a Form 8453 designating a financial institution to receive a tax refund does not give a taxpayer legal entitlement to have the Service honor this request. Likewise, it is clear the Service did not intend to create a substantive right for which taxpayers would have a remedy in the event the Service chose not to honor the taxpayer's request. The electronic refund procedure does not implicate any constitutional rights of a taxpayer.

In summation, under the authority of section 6402 of the Code, the Commissioner has the authority to dishonor taxpayers' requests made on Form 8453 to have their income tax refunds deposited into their accounts at financial institutions via EFT. However, the Service has published guidance to the public on the subject of the electronic transfer of tax refunds by way of Form 8453, Form 8302, and Announcement 85-14. If the Service wants to change its general policy of honoring these types of requests, we suggest that the Service revise its guidance in order to avoid potential claims of reliance on previously issued guidance.

Assignment of Refund Claims and the Anti-Assignment Act

The Anti-Assignment Act, 31 U.S.C. § 3727, provides that any assignment of a claim for refund is null and void against the Service unless certain statutory requirements are satisfied. To be enforceable against the Service, an assignment must meet three requirements. First, the Service must have determined the amount of overpayment, allowed the claim, and authorized payment. Second, the taxpayer must have freely made the assignment.

Third, the taxpayer must have executed the assignment in the presence of at least two attesting witnesses before a notary public.

The Supreme Court has summarized the Act's purposes. These rather technical requirements are intended to prevent persons of influence from buying up claims against the United States which might then have been improperly urged upon officers of the government; to prevent possible multiple payments of claims and to enable the government to deal only with the original claimant; and to ensure that the United States is able to avail itself of the defenses of set-off and cross-claims against the original claimants which might not be applicable to an assignee. See United States v. Shannon, 342 U.S. 288 (1952).

Under the Anti-Assignment Act, assignments of a claim for refund are not effective until the Service has allowed the claim. If taxpayers request the Service to send their refunds via EFT into a third-party's account at a financial institution before the Service determines the amount of overpayment, this request would be void and unenforceable under the Anti-Assignment Act. Accordingly, the Service is statutorily prohibited from honoring this assignment.³ See also section 301.6402-2(f) of the regulations.

One court has addressed the question of whether a designation to pay a refund to a RAL account is an assignment. In re Martin, 167 B.R. 609 (Bankr. D. Or. 1994). A Chapter 7 trustee brought an adversary proceeding to recover the debtors' tax refund that the Service had transmitted to a bank pursuant to a RAL designation. In deciding the case, the court examined the application of the Anti-Assignment Act to the debtors' RAL agreement. The court found that, by sending the debtors' refund to the bank for deposit in the debtors' RAL account, the Service had transmitted the refund to the debtors, not to the bank. That is: the Service had merely paid the refund to the taxpayers' account pursuant to a payment designation; the Service had not honored an invalid assignment to the bank. In re Martin, 167 B.R. at 614. However, under state law, the debtors' purported assignment of their contingent right to their income tax refund did grant the bank an equitable interest in the debtors' tax refund. In the alternative, the court held the bank had a security interest in the debtors' tax refund.

³ A refund suit brought by the assignee of the void assignment of a claim for refund is subject to dismissal. However, the assignor of the claim still has the ability to bring suit. Wall Industries, Inc. v. United States, 10 Cl. Ct. 82, 106 (1986).

Based upon the rationale of In re Martin, taxpayers' requests to deposit their refunds into their RAL accounts at financial institutions do not constitute invalid assignments under the Anti-Assignment Act. The refunds are paid to the taxpayers, not to the third-party financial institution. Only after payment to the taxpayer does the financial institution apply the funds in the taxpayer's account to satisfy the RAL and related lender and preparer fees.⁴

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⁴ The Automated Clearing House (ACH) procedures also address assignment. 31 C.F.R. section 210.1 et seq. provides that, in order for a taxpayer to receive his electronic refund, a taxpayer must designate a financial institution and an account using the enrollment procedures prescribed by the Financial Management Services for payment. The title of the account must be in the name of the taxpayer. If the account title is changed from the name of the taxpayer, by either removing or adding a name of a beneficiary or altering the interest of a beneficiary, then the ACH enrollment payment mechanism is terminated. Furthermore, the ACH procedures may not be used to effect an assignment of payment.